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# Company voluntary arrangements (CVAs):

## Recent trends in pandemic-era CVAs and what lies ahead?

February 2021





# Key messages

- In 2020, the first full year of the global COVID-19 pandemic, there were fewer CVAs than the prior year, partly due to **government support measures** that have **temporarily shielded** debtors from enforcement action.
- Those measures are **not a permanent fix**. In many cases **debts have been deferred, rather than released**, and have been building up on balance sheets. **As the support tapers off, we expect more businesses to require debt compromises** to improve cash-flow and mend their broken balance sheets.
- **The CVA is a powerful formal restructuring tool** that can be used to impose a compromise on unsecured creditors who will not compromise consensually. **A majority of 75% by value of voting unsecured creditors can bind dissenting unsecured creditors.** Sometimes the mere prospect of a CVA is enough to persuade creditors to engage in reaching a compromise.
- **The most active sectors for recent CVAs have been retail, hospitality and leisure**, where the CVA has been used predominantly to compromise property lease liabilities. **Tenants have been able to write-off rent arrears, vary the terms of leases to restore the viability of under-performing sites, and exit entirely sites that cannot be restored to viability.**

The main trends that we have seen in pandemic-era CVAs aimed at compromising lease liabilities are:



write-downs of rent arrears;



a shift towards turnover rent terms;



more severe future rent reductions;



rent holidays or waivers for future lockdown periods;



more unviable sites being exited entirely.

- The CVA can be used in many other contexts. **As we emerge from the pandemic, we expect more struggling companies to consider using a CVA to address their financial difficulties.**
- In this briefing, we summarise:
  - the CVA process;
  - recent trends in pandemic-era CVAs; and
  - issues to be mindful of in future CVAs.



# The CVA process – in a nutshell (1)

- A CVA is a **statutory tool**, available under the Insolvency Act 1986. It can be used by a debtor company to compromise unsecured claims against it, or to give effect to some other restructuring of its affairs.
- The process is **initiated by the company's directors** (or an administrator or liquidator of the company) making a **proposal** to the company and its creditors, for example to only pay a certain percentage of its debts in full and final satisfaction of those debts.
- The **proposal must be endorsed by a licensed insolvency practitioner**, who is known as a “nominee” of the CVA while the CVA is being proposed, and a “supervisor” of the CVA if it is approved and therefore needs to be implemented.
- The company's creditors and shareholders vote on whether to approve the proposal. **Creditor approval requires:**
  - **at least 75% by value of voting unsecured creditors to vote in favour** of the proposal; and
  - **no more than 50% of the total value of unconnected unsecured creditors to vote against** the proposal.

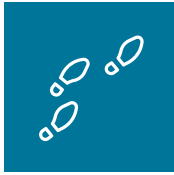




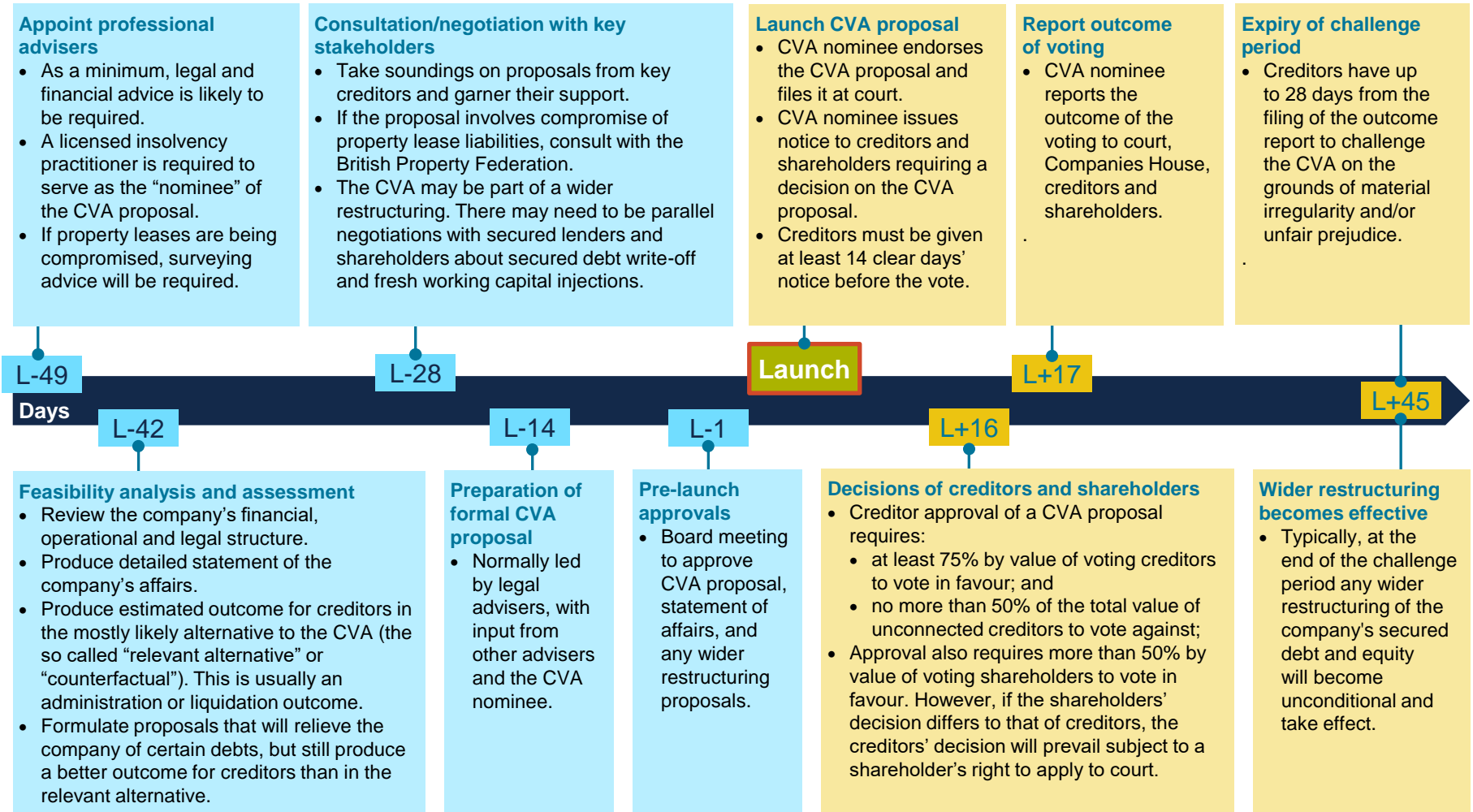
## The CVA process – in a nutshell (2)

- **Shareholder approval requires more than 50% by value of voting shareholders**, to vote in favour of the proposal. However, if the shareholders' decision differs to that of creditors, the creditors' decision will prevail, subject to a shareholder's right to apply to court.
- The advantage of a CVA is that if the proposal is approved by enough creditors, the proposal **binds all unsecured creditors**, irrespective of whether or how they voted, subject to some exceptions and a creditor's right to challenge the CVA. **This avoids the need to negotiate and reach agreement with each creditor individually.**
- A CVA **cannot compromise the rights of a secured creditor** to enforce its security **or the "preferential" debts of preferential creditors**, without their express agreement. Preferential debts are debts that are afforded a special priority in an administration or liquidation, for example certain employee claims and debts owing to HMRC.
- A CVA **can be challenged** on grounds of **material irregularity** and/or **unfair prejudice**.
- **An overseas company with business interests in the UK can use a CVA**, in certain circumstances.





# The CVA process – indicative timeline and steps





# Pre-pandemic CVAs used to compromise lease obligations

Even before the pandemic, CVAs were being used extensively, particularly by retail, hospitality and leisure businesses seeking to rationalise their leasehold commitments. In the three years prior to the pandemic, a long list of household names availed of the CVA, including **Toys R Us, House of Fraser, Mothercare, Carpetright, Arcadia, Debenhams, Jamie's Italian Restaurants**, and **Byron Burger**. In many cases, these were targeted at compromising landlords' claims only, although some also sought to compromise business rates liabilities. Often the CVA was part of a wider restructuring in which secured creditors and shareholders agreed new debt and equity arrangements, conditional on approval of the CVA.

The typical approach in these CVAs was to **group leases into different categories**, with each category being treated differently under the CVA to achieve the CVA company's commercial objectives. Broadly, leases have been categorised along the following lines.

<b>Viable leases</b>	The <b>terms</b> of these leases would <b>remain the same</b> , although payments would sometimes be moved from quarterly to monthly payments.
<b>Leases capable of viability, if terms amended</b>	These leases would be <b>varied to ensure the viability of the leased premises</b> . Often this would be achieved by imposing a future rent reduction on the landlords for a rent concession period of two to three years.
<b>Leases unlikely to be viable or not of strategic importance, even on varied terms (exit sites)</b>	These <b>lease obligations</b> would be <b>compromised in full</b> and landlords would be invited to "take back" their property. Typically, this category of landlords would be offered payments and/or access to a compensation fund designed to give them more than they would receive in the relevant alternative of an administration or liquidation.



# How successful were these pre-pandemic CVAs?

- The answer depends on how one measures success. The **vast majority** of the high-profile CVAs launched to address leasehold liabilities **were successful** in terms of achieving voting approval, often in percentages much greater than the requisite 75% by value threshold.
- It is notable that **all unsecured creditors have a vote in a CVA, even if their rights are not being compromised under the CVA**. This enables the votes of landlords whose rights are not being compromised (or whose rights are being compromised, but on acceptable terms) and the votes of other creditors such as suppliers and pension schemes to outweigh the votes of landlords whose rights are being heavily compromised.
- However, in many of the cases mentioned above the CVA companies failed in a relatively short timescale after the CVA was approved, owing to other fundamental issues not addressed by the CVA, or to subsequent developments. This illustrates that **a CVA may not be the right solution for all businesses** and that **additional operational and financial measures may be required to achieve a sustainable business**.





# Recent trends in pandemic-era CVAs (1)

Since the onset of the pandemic, we have seen a new wave of businesses, similar to those referred to above, avail of the CVA.

These include retailers such as **New Look** and **Clarks**, hoteliers such as **Travelodge**, and casual dining and takeaway businesses such as **The Restaurant Group**, **Wasabi**, **Pizza Express**, **Wahaca**, **Caffè Nero** and **Leon**.

In these CVAs, a similar approach has been taken to the categorisation of leases, but with some **progression in the treatment of those categories and other key terms attributable to the pandemic**.





# Recent trends in pandemic-era CVAs (2)

## Write-down of arrears

Government imposed lockdowns have required many businesses to close their doors for extended periods of time. This has significantly impacted income generation at affected premises and resulted in substantial arrears of unpaid rent and service charge.

With trading conditions predicted to be challenging for some time to come, we have seen CVA proposals incorporating substantial write-downs of such arrears, to **“wipe the slate clean” and allow future income to service future obligations.**

## Shift to turnover rent terms for future rent

We have also seen more CVA proposals switching rental payments from fixed amounts to amounts payable by reference to **turnover** from the leased premises, sometimes underpinned by a low minimum guaranteed rent that is a percentage of the contractual rent. This is justified on the basis that further lockdown measures may be imposed with little certainty as to when and for how long. If the rent were to be reduced by a fixed percentage only, this may not be sufficient to ensure the viability of the relevant premises in the face of future trading restrictions.

As with pre-pandemic CVAs, this is **typically for a rent concession period of two to three years.** We have seen different examples of how rent is to be treated at the end of the concession period. In some cases, the CVA has provided for a **return to the contractual rent** (see Clarks and Leon). In other cases the CVA has provided for rent to shift to **the higher of the market rent or a percentage of the contractual rent** (see Wasabi).

## More severe rent reductions

Where rent is compromised as a percentage of contractual rent, the **percentage discounts have increased.** This reflects the tough trading conditions facing tenants and the level of discount required to ensure the viability of premises while difficult trading conditions persist.



# Recent trends in pandemic-era CVAs (3)

## Rent holidays or waivers during lockdowns

Some recent CVAs have also included **express terms designed to assist the tenant company in the event of mandatory closure** of their premises during the concession period.

For example, Leon's CVA provides that if the company is required to shut its doors, during the period of closure, Leon is only obliged to pay 25% of the compromised rent.

Some CVAs, such as Wasabi's CVA, have gone further still and fully **waived the requirement for rent to be paid during any period of closure imposed by a government lockdown** – whether national or local.

## More exit sites

We have seen a **slight increase in the number of sites categorised as exit sites**. For retail businesses, this is partly linked to the pre-pandemic growth in online sales compared to sales through physical stores, which has been accelerated by the pandemic.

For retail, hospitality and leisure businesses, this is probably also attributable to current and anticipated **changes in consumer behaviours attributable to the pandemic** - for example less demand in crowded cities and increased demand in suburban towns.

## Other stakeholders and wider restructuring conditions

**Most of the pandemic-era CVAs in retail, hospitality and leisure have continued to focus on compromising property lease liabilities rather than a broader pool of creditors.** This is often justified on the basis that the debts of other creditors do not need to be compromised to restore the company's financial position or that the debts cannot be compromised without unduly damaging the business.

That said, in many cases, the CVA has been part of a **broader restructuring** in which other key stakeholders such as secured creditors and shareholders have contributed by accepting a debt write-down and/or providing fresh capital, conditional on the CVA being approved and not challenged. For example, in the case of Wahaca, the secured creditors and existing shareholders agreed to write off a large percentage of the existing indebtedness and provide fresh working capital of £5 million.



# Clarks' CVA – key features

<b>Lease categories</b>	<b>10 categories</b> <ul style="list-style-type: none"><li>• Leases not compromised (85)</li><li>• Leases partially compromised (177)</li><li>• Leases fully compromised / exit sites (81)</li></ul>
<b>Arrears of rent (UK leases only)</b>	<ul style="list-style-type: none"><li>• Leases not compromised - arrears of rent paid in full (although for a subset of the leases not subject to a future rent compromise, the arrears were fully written off)</li><li>• Leases partially compromised - arrears of rent fully written off</li><li>• Leases fully compromised / exit sites - arrears of rent fully written off (as well as full write-off of future rent)</li></ul>
<b>Future rent compromises during concession period of 3 years</b>	<ul style="list-style-type: none"><li>• For the leases partially compromised, a move to turnover rent of between 4% to 12% of turnover (dependent on categorisation), subject to a minimum base rent in the second and third years of the rent concession period of 85% of the previous year's compromised rent</li></ul>
<b>Post-concession period</b>	<ul style="list-style-type: none"><li>• Reversion to pre-CVA contractual terms</li></ul>



# Wasabi's CVA – key features

<b>Lease categories</b>	<b>4 categories</b> <ul style="list-style-type: none"> <li>• Leases not compromised (16)</li> <li>• Leases partially compromised (28)</li> <li>• Leases fully compromised / exit sites (12)</li> </ul>	
<b>Arrears of rent</b>	<ul style="list-style-type: none"> <li>• Leases not compromised - arrears of rent paid in full</li> <li>• Leases partially compromised - 90% of arrears of rent written off</li> <li>• Leases fully compromised / exit sites - 90% of arrears of rent written off</li> </ul>	
<b>Future rent compromises during concession period of 2 years</b>	<b>Category B:</b> For each site, the higher of: <ul style="list-style-type: none"> <li>• Category B Lease MGR (initially 30% of contractual rent and rising to 45%); and</li> <li>• Category B Lease CVA Turnover Rent (which is a % of net sales, where the % is based on the % of FY19 contractual rent to FY19 net sales)</li> </ul>	<b>Category C:</b> For each site, the higher of: <ul style="list-style-type: none"> <li>• Category C Lease MGR (initially 20% of contractual rent and rising to 40%); and</li> <li>• Category C Lease CVA Turnover Rent (9% of net sales)</li> </ul>
<b>Post-concession period</b>	<ul style="list-style-type: none"> <li>• Category B - contractual rent multiplied by the total turnover in the last 12 months of the CVA divided by total FY19 turnover</li> <li>• Category C – the greater of (i) the amended contractual rent in the 12 months before the end of the rent concession period and (ii) 50% of the contractual rent</li> </ul>	



# Increased imperative to restructure as support measures taper off

During the pandemic, the UK government introduced a wide range of support measures to help shield debtors from enforcement action. These include **moratoria on forfeiture action and winding-up petitions**, and **deferral of rates liabilities**. These measures are currently **due to taper off as early as the end of March 2021**. As this happens, landlords and other creditors will have greater freedom to take enforcement action against underperforming tenants.

This does not mean that landlords will not be supportive of struggling tenants – **it may make commercial sense to keep a tenant in occupation, even if less than contractual rent is being recovered**. This is because the prospects of re-letting on better terms are limited and during void periods a landlord is liable for rates and other liabilities connected to their premises.

Nonetheless, **as the government support diminishes, we expect more businesses to require a more permanent restructuring of their obligations**. A CVA is one of the tools that can be considered to help achieve this.





# How will landlords react to future CVA proposals?

In the main, during the pandemic so far, **we have seen landlords being realistic** about what they can expect from tenants whose businesses have been severely impacted by government restrictions on trade. Although pandemic-era CVAs have sought greater compromises from landlords than before the pandemic, **these CVAs (like those launched before the pandemic) have tended to be approved with levels of unsecured creditor support well above the minimum 75% by value threshold.**

This realism has also been displayed by one of the leading industry bodies for landlords, the British Property Federation (BPF). Since before the pandemic, the **BPF** had issued “**Red Flags**” – a set of criteria that it and its members expect to see given due consideration in any CVA proposal that seeks to compromise lease liabilities (see the next slide for a summary of the Red Flags). During the pandemic, we have seen a slightly more **flexible approach** in their consideration of the Red Flags. For example, CVAs in which the debts of trade creditors (other than landlords) have not been compromised, that have received tacit support.

That said, **landlords remain sceptical of CVAs that target only landlords while other creditors continue to be paid in full**, and they voice concerns about how far the “envelope is being pushed”. This can be seen in the BPF’s new year statement, in which it is lobbying government to overhaul the CVA process in five key areas, with a view to lessening the impact of CVAs on its landlord members. The BPF wants to see...

## BPF’s requests for reform of CVAs

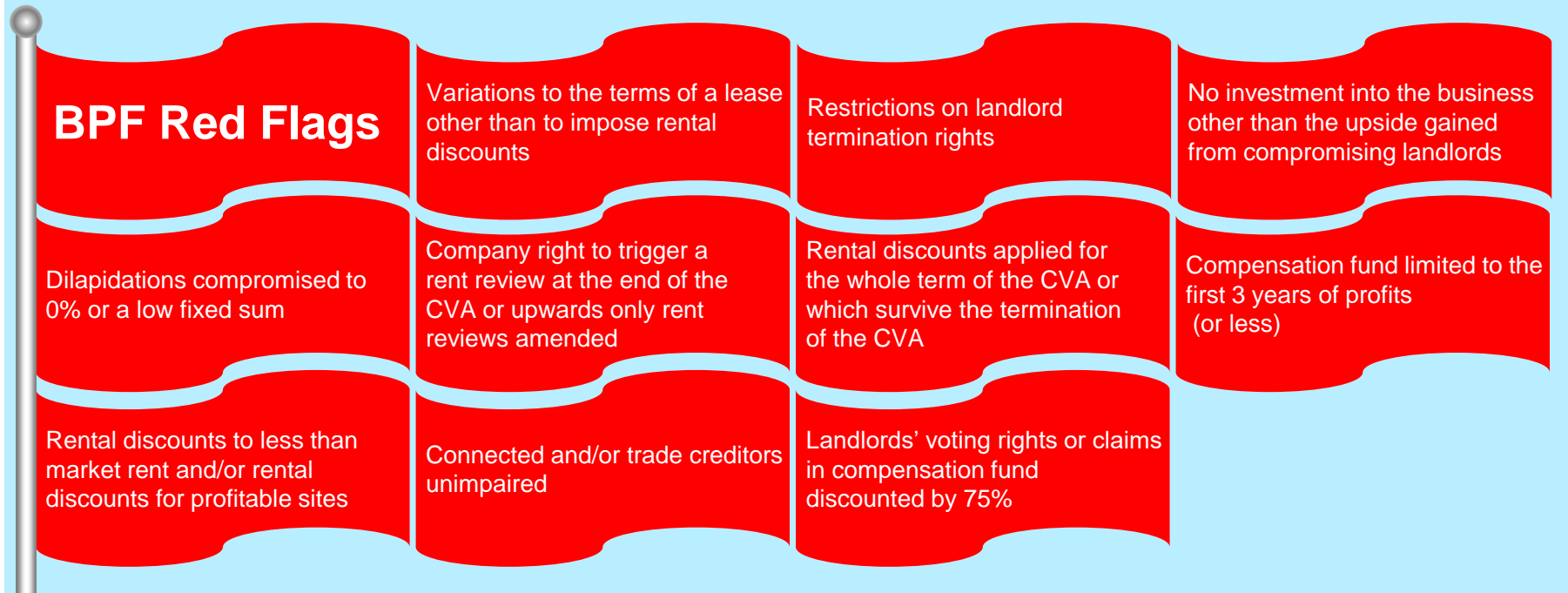
- 1) independent scrutiny of large CVAs;
- 2) outlawing the ability of a CVA to make permanent changes to contracts;
- 3) an extension to the notice period given to creditors, from 14 to 28 days, to allow for greater scrutiny of the CVA proposals;
- 4) amendments to the voting rules so that greater weight is given to those creditors directly impacted by the CVA; and
- 5) clarification on how rent is factored into voting on CVA proposals, to prevent manipulation of the creditor vote against landlords.



# The British Property Federation (BPF) - Red Flags

In any CVA that proposes to compromise lease liabilities, due consideration should be given to the BPF's "Red Flags". The BPF is one of the leading industry bodies for landlords. While it is individual landlords who vote on a CVA proposal, how the BPF views that proposal can have a significant impact on how landlords vote. **It is good practice to consult the BPF early in the CVA process. If the BPF supports a CVA proposal, it has a greater chance of being supported by landlords generally.**

The BPF has issued ten "Red Flags". These are key terms of a CVA proposal which, if they are not to satisfaction of the BPF, may cause it to recommend that landlords vote against a CVA.





# Wider uses of CVAs

Although we have focused on the high profile cases in which CVAs have been used to rationalise large leasehold portfolios, CVAs can be used by enterprises of all sizes and to compromise a wide range of other unsecured debts, not just lease liabilities.

**Any business that has built up unsustainable unsecured debts during the pandemic, can consider whether a CVA would enable them to reduce that debt burden in a fair and equitable manner.** Typically, the earlier action is taken, the greater scope there is to achieve an outcome that benefits the debtor, its creditors and its shareholders.

**Other recent law reforms** introduced to help mitigate the effects of the pandemic **may also assist.** For example the **measures to prevent suppliers from terminating contracts** solely on the grounds of insolvency (which is subject to various exceptions and safeguards for suppliers) and the **new standalone moratorium** that is available to companies in need of a “breathing space” while a restructuring is formulated.





# CMS' restructuring team

CMS' Restructuring & Insolvency team has an established reputation for delivering expert advice and solutions to all types of stakeholder at all stages of the restructuring process.

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